



An economic analysis of dismissal legislation: Determinants of severance pay in West Germany

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ABSTRACT

Severance pay is a vital part of employment protection legislation (EPL). We investigate the incidence and level of severance pay for dismissed employees. Our theoretical model predicts that not only the law and its interpretation by labour courts but also the costs of a suit have an impact. Using West German panel data for 1991–2006, we find that the employees' costs resulting from a suit and the legal determinants of such transfers affect the incidence of severance payments. In contrast, their level only varies with legal regulations. Our results imply that the strictness of EPL in Germany varies with extra-legal factors like employees' financial constraints.

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1. Introduction

Despite recent reforms, employment protection legislation (EPL) in Germany is still regarded as comparatively strict (see OECD, 2004; World Bank, 2006). However, employers can circumvent restrictive regulations by making a sufficiently high severance payment. Accordingly, the majority of such payments in Germany result from private agreements between firms and employees. Yet even if severance pay arises from a negotiation, EPL and its interpretation by labour courts can have a strong impact. This is because employees may initiate a court procedure to enforce the restrictions on dismissals which EPL constitutes. In this paper we investigate the impact of legal criteria as well as of the costs of enforcing EPL on severance payments (see, e.g. Bertola, Tito, & Cazes, 1999). The analysis can provide insights as to whether the legal rules – underlying, for example, the OECD's and World Bank's evaluations – are an adequate proxy for the actual extent of employment protection.

In consequence, we also contribute to the debate on the distinction between the law in action and law on the books (Jolls, 2004, 2007). Finally, our estimates enable us to calculate a lower bound of the expected costs of a dismissal. Knowing such costs can help in evaluating the strictness of EPL in Germany.

Subsequently, in Section 2 we describe the legal situation in Germany and survey the relevant empirical studies. In Section 3, we present a theoretical model of severance pay determination which allows for all major observable consequences: namely, a dismissal without a severance payment, an agreement between firm and employee including a payment, and outcomes involving a labour court. We inquire how the prevalence and magnitude of severance payments are affected by variations in parameters which, first, are defined by law as determinants of EPL and, second, affect the costs of a legal dispute. In Section 4 we describe the dataset, the German Socio-Economic Panel (SOEP), and the empirical specifications used. In Section 5 we put our theoretical hypotheses to an empirical test. We find that the probability of obtaining severance pay and its level are indeed affected by legal determinants. In addition, the probability increases with the employee's costs of losing a job and declines with those of a legal dispute. Our results indicate that the expected costs of a dismissal and, more generally, the strictness of EPL as a proxy for the law

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in action differ substantially from the law on the books. Therefore, indices of EPL based on the latter, such as that used by the OECD (1999, 2004), may misrepresent the actual extent and severity of EPL in Germany. To illustrate our results, we focus on a selection of “typical” employees. Our most common employee obtains a payment with a probability of 14% and its real expected level is about € 900. If this employee is a member of a trade union, the probability of obtaining a payment more than doubles, while the non-applicability of the central law regulating dismissals reduces it to less than 1%. In Section 6 we conclude. The Appendix contains some of the derivations and additional information on the data.

Our paper is related to analyses of EPL which explicitly incorporate the legal process and allow for an interaction between firms and workers, on the one hand, and courts on the other. Ichino, Polo, and Rettore (2003), for example, present a model of the litigation process against the backdrop of the Italian legal situation. They investigate theoretically whether labour market conditions are reflected in court outcomes and find empirical evidence for such a relationship. Malo (2000) views bargaining about payments in the case of individual dismissals in the context of the Spanish legal situation as a game of incomplete information. He shows, *inter alia*, that the amount demanded increases with the expected award by the court and declines with the employee’s costs of filing a suit. Malo and Pérez (2003) extend the model to enhance its applicability beyond the Spanish context. None of the approaches outlined above focuses on a distinctive feature of German EPL: severance pay can result from offers by firms and can also be court-induced, but there is no universal entitlement. Hence, the probability of obtaining a payment is determined endogenously and affected by employee- and match-specific features. While we investigate the impact of income taxes in a companion paper (Goerke & Pannenberg, 2009), in the present contribution we analyse an extended model which explicitly allows for court verdicts and focuses on these employee- and match-specific effects, as well as the costs of enforcing EPL.

Our contribution is also associated with analyses assuming that a labour court may erroneously evaluate the cause of a dismissal (Besancenot & Vranceanu, 2009; Galdón-Sánchez & Güell, 2003; Huang, Chang, & Lai, 2009; Stähler, 2008), and that a court can affect the incentives to undertake match-specific, productivity-enhancing investments (Deffains, Gabuthy, & Lambert, *in press*). From a wider perspective, we touch upon the literature on litigation and settlement as recently surveyed, for example, by Spier (2007) and Daughety and Reinganum (*in press*).

2. Legal background and previous evidence

2.1. Employment protection legislation in Germany

EPL in Germany stems from a multitude of sources.¹ First, the German Civil Code (“Bürgerliches Gesetzbuch”, § 622) establishes notification periods for dismissals, except in cases of gross misconduct. These amount to at least 4 weeks for employees aged over 25 years and rise with tenure. Of particular importance is, secondly, the Protection against Dismissal Act (PADA, “Kündigungsschutzgesetz”). The PADA (§ 1) states that dismissal of an employee with more than 6 months tenure is invalid, unless there is (1) personal misconduct, (2) a lack of individual capabilities (including

¹ More extensive descriptions of EPL in Germany in English are provided, for example, by Bertola et al. (1999), and Eger (2003). Additional protection against dismissals – not discussed further below – may result from collective bargaining agreements. More restrictive rules also apply to apprentices. Moreover, members of the works council, expectant mothers, and employees on parental leave can essentially not be dismissed.

absenteeism due to sickness), or there are (3) compelling operational reasons, including redundancies. In the third case, the PADA requires that firms select workers or employees – terms we use interchangeably here – to be dismissed in accordance with criteria such as age, tenure, the extent of alimony duties, and individual disabilities.² The regulations of the PADA have generally applied to all firms with more than five permanent employees.³

Given applicability of the PADA, a worker – supposed to be male for simplicity – can file a labour court suit to contest the termination of his contract. In court, a conciliation procedure takes place initially. During the course of this the judge usually suggests a mutual agreement. If none is reached, the court procedure will eventually end with a verdict, unless a compromise is found beforehand. Each party bears its own costs of legal representation which is, however, not compulsory in labour courts until a verdict is contested. Only if a judgement is passed, will a comparatively small court fee be imposed. In Germany, about 200,000 dismissal disputes were brought to court in 2007, of which the overwhelming majority were settled by a mutual agreement or withdrawn by the litigant, most likely because a private settlement was found.⁴

In general, an unlawful dismissal does not result in a reinstatement to the previous job. This is the case since the PADA (§ 9) stipulates that the court can dissolve an employment contract if its continuation cannot be expected either of the worker or the firm. Only in such an instance must the court award a severance payment. The PADA provides no detailed rules for its amount, solely defining a ceiling of 12 monthly gross wages that increases up to 15 (18) monthly wages for workers of at least 50 (55) years of age and with a minimum of 15 (20) years of tenure. A survey of labour courts revealed that more than 75% utilise a specific formula according to which severance pay is related linearly to the product of tenure (in years) and the last monthly gross wage. The characteristics of each case are then incorporated by modifying the amount calculated in line with this severance pay formula. In particular, payments decrease with the re-employment probability and rise with age, the extent of pension entitlements forfeited due to the job loss, alimony payments, and also firm size.⁵

The Works Constitution Act (GWCA, “Betriebsverfassungsgesetz”) represents a further important source of EPL. This Act stipulates that any dismissal of which a works council has not been informed in advance is null and void. In addition, with the exception of cases of gross misconduct, a firm has to continue employing a worker whose dismissal has been opposed by the works council and who has filed a suit at the labour court until the case is settled (§ 102 GWCA). Moreover, § 112 GWCA defines specific rules for mass dismissals. In principle, employees can enforce a “social plan”, usually including severance payments. Often, similar criteria determining the magnitude of severance pay apply as for individual dismissals. Note though that since works councils are not pervasive, in 2006 the regulations of the GWCA applied to about 46% (10%) of the employees (firms) in West Germany (Ellguth & Kohaut, 2007). Finally, the Social Code IX (§§ 85 ff) will require the formal approval

² These criteria have been mentioned explicitly in the PADA only from 1996 to 1998, with the exception of disabilities, and again since 2004. However, labour courts have usually applied similar criteria.

³ The threshold increased to ten permanent employees from October 1996 to January 1999, was reduced to five permanent employees afterwards, and has in principle been raised again to ten employees at the beginning of 2004. See Bauer, Bender and Bonin (2007) for an analysis of the effects of these changes on worker turnover.

⁴ See http://www.bmas.de/coremedia/generator/29660/property=pdf/statistik_der_arbeitsgerichtsbarkeit_2007.pdf for this (in German).

⁵ See, e.g. Hümmerich (1999), Spilger (2007, p. 565 ff), and Höland et al. (2007, p. 161). Since 2004 there is a passage (§ 1a) in the PADA which explicitly defines severance pay for particular cases of dismissals as the product of half the monthly gross wage and tenure.

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